Internationalisation and the performance of German firms

Nejat Capar

Department of Management,
Bang College of Business,
Kimep University,
Abay Ave. 2, 050010, Almaty, Kazakhstan
Email: ncapar@kimep.kz

Abstract: Internationalisation contributes to the growth and profitability of firms. Many earlier studies have examined this relationship and the various studies that examined this relationship have found conflicting results. In addition, some studies have suggested that the relationship between internationalisation and performance is curvilinear. There has been some support regarding the curvilinear hypothesis. On the other hand, most of the earlier studies have tested the internationalisation-performance relationship on samples of US firms. This study has examined the relationship between internationalisation and performance on a sample of German firms. Results show that there is support for the linear effect between internationalisation and performance.

Keywords: Internationalisation; German firms; firm performance; multinationality; international diversification.

Biographical notes: Nejat Capar received his PhD in Strategic Management from the Florida State University. He is currently serving as a faculty member and as the Dean at KIMEP University's Bang College of Business. Before joining KIMEP University, he has taught at universities in the USA, UAE and Turkey. His primary research interest focuses on internationalisation and performance of firms.

1 Introduction

The internationalisation of firms and their performance has been an important subject for quite some time (e.g., Buckley and Casson, 2009; Daniels and Bracker, 1989; De Jong and van Houten, 2014; Delios and Beamish, 1999; Geringer et al., 1989; Doukas and Lang, 2003; Geringer et al., 2000; Gomes and Ramaswamy, 1999; Grant, 1987; Haar,

1989; Hitt et al., 1997; Hsu et al., 2013; Leung and Sharma, 2021; Singla and George, 2013; Sun et al., 2019 Tallman and Li, 1996 ; Xiao et al., 2013). Internationalisation refers to a firm's expansion beyond its national markets. The terms international diversification, multinationality, and international diversity are often used interchangably in the literature. In this paper, we use rather the term internationalisation for consistency purposes.

Internationalisation provides not only growth opportunities for firms but also the chance to increase profitability as it allows firms to increase sales and at the same time decrease its costs (Ansoff, 1965; Capar and Kotabe, 2003), which has major potential impact on firm performance. Despite many studies that analysed the association between internationalisation and performance, these efforts have not provided consistent results (Capar and Kotabe, 2003). Several studies have pointed to potential methodological and theoretical factors that could explain to some degree the inconsistent results (Hennart, 2011; Kirca et al., 2011; Nguyen, 2017). Consequently, more recent studies have focused on non-linear forms of a relationship between internationalisation and performance as opposed to a linear relationship, which has been the underlying premise in earlier studies (Gomes and Ramaswamy, 1999; Hitt et al., 1997).

There still is not sufficient evidence to date with respect to the nature of relationship between internationalisation and performance. Furthermore, the majority of previous studies that examined the internationalisation-performance relationship were based mostly on US samples. Thus, it is likely that due to conditions specific to US firms, the findings of such studies might not be relevant to firms from other countries due to their different conditions. Therefore, this study is based on German firms spread over five industries for a three-year period.

In the remainder of this paper, we will first discuss the literature and theory on internationalisation-performance relationship, followed by the research methods used in this study. Finally, we will discuss the results and the contributions of this study along with providing future directions for research.

2   Literature review

2.1   *Internationalisation and firm performance*

Internationalisation is one of the strategic options used by firms for fast growth, which leads to market expansion, as this results in operations across multiple counties (Bausch and Krist, 2007; Bianchi and Ostale, 2006; Javalgi and Todd, 2011; Kirca et al., 2011; Singla and George, 2013). Managers realise the benefits of internationalisation in terms of resource sharing, information transfer, increase in performance of the firm in terms of firms return on investments, customer reach (Glaum and Oesterle, 2007; Lu and Beamish, 2004), reduced risk for the firm (Kwok and Reeb, 2003) and profitability (Lavie and Miller, 2008). Recent literature has witnessed the contribution of internationalisation on the performance of firms. However, some of the reports provide contradicting results, which suggests that the effect of internationalisation on performance of the firm is not consistent. On one side, studies confirms that internationalisation leads to better firm outcome in terms of return on investments, profitability of the firm, earnings better utilisation of resources (Chen and Hsu, 2010; Lavie and Miller, 2008; Zhou et al., 2007). Firms learn new market environment and

invest incrementally to get better ROI (Douglas and Craig, 2011; Kamakura et al., 2012). The process allows firms to increase their level of awareness about international transactions, which leads to growth as the engagement of the firm increases with other countries (Singla and George, 2013). In contrast, other researchers find that internationalisation leads to several complexities, increases risk and results in reduction in firm's strength (Kwok and Reeb, 2000). There are reports which suggest that internationalisation leads to mixed results (Lu and Beamish, 2001). We have categorised these aspects into four aspects in the following section.

First, as per theory of internationalisation, increase in the level of firm specific assets along with more attention to transaction cost, results in better firm performance (Chi, 2015). Firms survive the increasing competitive pressure and rely on innate strength only (Buckley and Casson, 2016). Since firms get extended market coverage and enhanced customer base, this results in additional revenue to the firm. Expansion into the additional markets also results in achieving economies of scales to the firm (Contractor, 2007; Zhou et al., 2007). Economies of scales results in achieving better utilisation of resources, streamlining and optimising the assets which translate into higher firm's performance in terms of ROI and higher profitability (Chen and Hsu, 2010).

Second, as a result of internationalisation, firms create learning opportunities. These learning opportunities, firms convert into innovation. Effect of innovation on performance of the firm has been well documented in the business literature (Clifton et al., 2010). The experience learned in one country is used and shared with the other international market to leverage the market (Ruigrok and Wagner, 2003). Products developed in one country, can be used in other countries to satisfy the customers. (i.e., GEs used reverse innovation from the Indian market to Western countries). These learning opportunities may help the firm to satisfy customers in the global market because of the managerial experience and knowledge (Inkpen and Dinur, 1998).

Third, internationalisation also leads to diversification, which allows firms to penetrate new product markets as well. Because of internationalisation, firms get a better chance to capture the evolution and get a first mover advantage (Chetty and Stangl, 2010). Firms may discover new opportunities apart from their existing product line and develop some new business lines to secure extra revenue (Hitt et al., 1997).

Fourth, firms may also save upon cost structure. Because of internationalisation, firms can secure lower costs for labour, research and development and production. This factor heterogeneity may result in reducing operational cost and secure better ROI and profits (Capar and Kotabe, 2003).

Literature also provides another perspective of the impact of internationalisation on a firm's performance. A contrary view suggests that internationalisation leads to a poor financial position of the firm (Bianchi and Ostale, 2006; Ruigrok et al., 2007). Since firms are engaged in multiple markets, it leads to financial burdens i.e., production, acquisition cost of customers, expenditure on relationship building activities, higher expenditure on operational cost because of simultaneous presence in multiple countries at same time. All may lead to increase in transactional cost. Non familiarities with different markets may result in managerial complexities, resource dilution and hence increase the cost (Capar and Kotabe, 2003; Hitt et al., 1997; Tihanyi et al., 2000). All these may lead to dilution in the firm's performance specially in competitive markets (Yeoh, 2004).

3   Theoretical background and hypotheses

3.1   *Internationalisation and firm performance*

Internationalisation brings many advantages to firms. According to Buhner (1987), internationalisation provides new market opportunities that allows firms to achieve further growth. The fundamental argument for internationalisation has been based on internalisation theory, which suggests that firms exploit proprietary assets and resources in international markets (Buckley and Casson, 2009; Caves, 1982; Hymer, 1960; Rugman, 1979, 1981). Internalising markets allows firms to reach several advantages such as economies of scale, scope (Ghoshal, 1987; Kim et al., 1989, 1993; Kogut, 1985), and sharing their competencies among different business segments and geographic markets (Hamel, 1991).

According to internalisation theory, firms that possess unique proprietary assets and competencies, which were developed at home, can exploit these through expanding into international markets (Bartlett and Ghoshal, 1989). Put differently, the exploitation of firm specific resources and proprietary assets in international markets will lead to expansion into international markets and consequently to better financial performance (Hymer, 1960, 1976). This view is primarily based on internalisation theory in international business literature (Buckley and Casson, 1976; Hymer, 1960) as well as the resource-based view of the firm in strategic management literature (Barney, 1991; Kogut and Zander, 1993).

Another stream of studies has examined a non-linear relationship between internationalisation and performance and have argued for a theoretical rationale to justify their position (Gomes and Ramaswamy, 1999; Hitt et al., 1997). The majority of the studies that assumed the relationship between internationalisation and performance as nonlinear did not provide sufficient theoretical explanations. Many of these studies have found an inverse U-shaped relationship, where performance first increases up to a certain point after which it starts to decrease, perhaps mostly due to inefficiencies that come with higher levels of internationalisation (Gomes and Ramaswamy, 1999; Hill et al., 1997).

Multinational firms also have the chance to integrate their international activities across the different countries in which they operate by streamlining production and configuring their value chain in the most effective and efficient way possible (Kobrin, 1991). In addition, international firms can also benefit profitably by exploiting market imperfections (e.g., less competitive markets) and using their unique firm resources to attain a stronger competitive advantage. Collectively, these arguments indicate that internationalisation should lead to better financial performance. In other words, a positive relationship is expected between internationalisation and firm performance. However, the results of various studies have not been conclusive. While some demonstrated a positive relationship (Daniels and Bracker, 1989; Gomes and Ramaswamy, 1999; Grant, 1997; Haar, 1989), others have shown no such relationship by observing either a negative relationship or no relationship at all (Kumar, 1984; Siddharthan and Lall, 1982). All these studies have assumed that the relationship between internationalisation and performance is linear (Gomes and Ramaswamy, 1999).

Several researchers have argued that at higher levels of internationalisation, particularly combined with product diversification and expansion into physically and culturally distant markets (Davidson, 1983; Eramilli, 1991; Papadopoulos and Denis, 1988), exacerbates the transaction costs and information processing demands (Egelhoff,

1982, 1988; Hitt et al., 1994). There are also additional factors that contribute to the complexity of operations such as government regulations, trade laws, and currency fluctuations (Sundaram and Black, 1992). These additional transaction costs and complexities ultimately reduce efficiency. To manage large international and complex organisations requires effective structures and systems, without which firms are faced with higher cost and with increased inefficiencies.

Over a period, the internationalisation process will adapt the developmental process from easy to complex. Therefore, initially the firm performance initially improves, then levels off and eventually declines. At early stage, multinational firms are confronted with relatively lower overseas uncertainties, which result in lower management cost at early stages of internationalisation. With the passage of time, when internationalisation grows so does the complexity of operations, which leads to higher management cost and results in lower performance.

In summary, such factors as described above, often increase the cost of international operations at higher levels of internationalisation. Thus, the higher the level of internationalisation, the more costly will be its operations. Therefore, performance will start to decline after a certain level, suggesting an inverted U-shaped relationship between internationalisation and performance. Several studies have found evidence in this regard. More specifically, these studies found that after a certain level of internationalisation, financial performance starts to decline (Gomes and Ramaswamy, 1999; Hitt et al., 1997). This optimum point is called the international inflection point and is usually distributed within the range of 50–80% (Yeh et al., 2021). In essence, these findings indicate that there is an optimal level of internationalisation, beyond which the financial performance starts to level off and eventually declines.

Considering these two streams of research, the linear and non-linear effects of internationalisation on performance can be stated as follows:

> *Hypothesis 1: The relationship between internationalisation and performance is linear.*

> *Hypothesis 2: The relationship between internationalisation and performance is non-linear (or curvilinear).*

4 Research methodology

4.1 Sample

The sample consists of German firms from five manufacturing industries, namely, chemical, electrical and electronics, pharmaceutical and drug, machinery and equipment, and the automotive industries. Data used in the empirical analysis were drawn from a variety of public information sources (Die Welt annual survey, directories, and annual reports). To be included in the sample, a firm had to:

1 be a manufacturing firm,

2 belong to one of the five industries used,

3 have at least 10% of their sales originating from abroad

4 have >70% of sales originating in one single business.

The five industries were chosen based on the rationale that a large portion of firms that operate in those areas are major players in international markets and that adequate number of firms were present in those industries (Gomes and Ramaswamy, 1999). Furthermore, the criterion of including firms with at least 10% of foreign sales has been used in earlier studies (e.g., Geringer et al., 1989; Gomes and Ramaswamy, 1999; Habib and Victor, 1991; Stopford and Wells, 1972). Finally, the reason for not including product diversified firms was to avoid the potential effects of such firms (Gomes and Ramaswamy, 1999; Hitt et al., 1997). The final sample consisted of 119 firms from five industries (chemical: 29, electrical and electronic goods: 33, pharmaceutical and drugs: 11, machinery and equipment: 23, and automotive: 23).

4.2   Variables and measures

Performance. Return of sales (ROS) was used to measure firm performance. The choice of using this accounting-based profitability measure was mainly due to data availability and due to the fact that many previous studies used this measure (e.g., Grant, 1987; Harr, 1989; Vernon, 1971). Although many other studies have used return on assets (ROA) for performance, data were not widely available on assets to compute ROA. However, Hitt et al. (1997) have indicated that both ROA and ROS have generated similar findings and that they were highly correlated ($r = 0.91$).

Internationalisation. As with previous studies, internationalisation has been operationalised as the ratio of foreign sales to total sales (FSTS) in this study (Grant, 1987; Habib and Victor, 1991; Stopford and Wells, 1972; Tallman and Li, 1996).

Control variables. In line with earlier studies (e.g., Gomes and Ramaswamy, 1999) firm size and industry effects were employed as control variables. Firm size, measured by the log of total sales, was used to control for the potential effect of scale economy differences. In addition, possible industry effects were controlled for by using four industry dummy variables, representing the five industries (I_1 = chemical, I_2 = electrical and electronic goods, I_3 = pharmaceutical and drugs, I_4 = machinery and equipment). The automotive industry is the residual dummy variable (i.e., when all I_s = 0).

4.3   Analysis

The two competing hypotheses as illustrated in the two regression equations presented below, that is the linear effect vs. the curvilinear effect of internationalisation on firm performance, were tested by using the ordinary least squares (OLS) method.

$$\text{Perf} = \beta_0 + \beta_1\text{Size} + \beta_2 I_1 + \beta_3 I_2 + \beta_4 I_3 + \beta_5 I_4 + \beta_6\text{Intl.} + e \tag{1}$$

$$\text{Perf} = \beta_0 + \beta_1\text{Size} + \beta_2 I_1 + \beta_3 I_2 + \beta_4 I_3 + \beta_5 I_4 + \beta_6\text{Intl.} + \beta_7\text{Intl.}^2 + e \tag{2}$$

Equation (1) represents the linear model, while equation (2) represents the curvilinear model, where the Intl.^{2} will be entered to test for curvilinearity. The curvilinear model will be supported if the R^2 associated with the curvilinear model (equation (2)) is higher than the linear model (equation (1)), and the coefficient of the squared term for internationalisation (Intl.) variable, β_7, is significant.

5 Results and discussion

Table 1 reports means, standard deviations, and the correlations for the variables used in the study. The correlations among the variables present no problem of multicollinearity.

Table 1 Means, standard deviations and correlations[a]

Variables	Mean	S.D	1	2	3
1. Firm profitability	0.03	0.02	1.00		
2. Firm size	3.70	0.50	−0.78	1.00	
3. International diversification	0.63	0.15	0.204*	0.212*	1.00

[a]$N = 119$; *$p < 0.05$.

Table 2 presents the results for both the linear model and the curvilinear model of the relationship between internationalisation and performance.

Table 2 Effect of international diversification on firm profitability

Independent variables	Linear model	Curvilinear model
Size	−0.132	−0.129
I_1	0.105	0.095
I_2	0.083	0.062
I_3	0.161	0.142
I_4	−0.053	−0.069
Intl. Div	0.231*	−0.175
Intl. Div^2		0.413
Adj. R^2	0.046	0.043
F	1.953[t]	1.76

[t]$p < 0.10$.
*$p < 0.05$.
**$p < 0.01$.
Size Firm size (log of sales).
I_1 Chemicals.
I_2 Electrical and Electronic.
I_3 Pharmaceutical and Drugs.
I_4 Machinery and Equipment.
Intl Div International Diversification.

The first model in Table 2 is an examination of the linear effect of internationalisation on ROS. As can be seen, there is a statistically significant positive relationship between internationalisation (Intl.) and performance at $p < 0.05$. The relationship is shown in Figure 1. This result is consistent with findings of other studies (Delios and Beamish, 1999; Gomes and Ramaswamy, 1999, and Hitt et al., 1997).

However, the overall model is significant only at the $p < 0.10$ level, with an Adj. R^2 of 0.046. It is also interesting to note that the effect of firm size on ROS is negative

although the relationship is not statistically significant. Also, the industry dummy variables show differing industry effects, none of which are statistically significant.

Figure 1   Relationship between internationalisation and firm performance (see online version for colours)
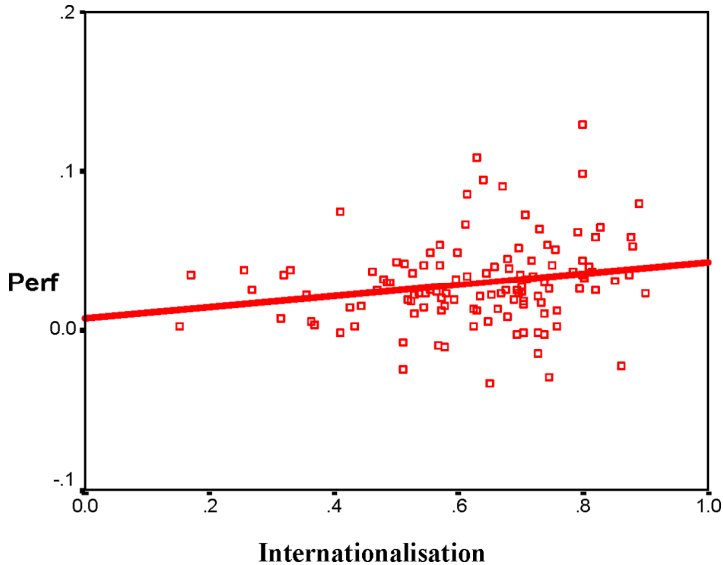
The second model in Table 2 shows that there is no support for the curvilinear effect (hypothesis). As can be seen, both the coefficient of the squared internationalisation term (Intl.2), 0.413, and the overall model are not statistically significant. In other words, the explanatory power of the model has not increased when the non-linear term, Intl.2, entered the model. The coefficient of 0.413 seems to suggest a strong curvilinear effect. However, it is statistically not significant, providing no support for the curvilinear relationship between internationalisation and performance.

The results of this study contradict earlier findings by Gomes and Ramaswamy (1999) and by Hitt et al. (1997), who both found evidence in favour of a curvilinear relationship between internationalisation and firm performance. This suggests two possible explanations. Either their findings are not stable enough, and thus require more empirical evidence. A second explanation might be that their evidence explains a true curvilinear-relationship, but these results don't necessarily apply to firms in other contexts. This is a possible situation since many theories in management are heavily relied upon US studies, and therefore might not be exactly applicable to other countries and cultures. In either case, it might be premature to quickly claim a universal curvilinear relationship between internationalisation and firm performance.

In fact, the present study shows an average internationalisation level of 63% for the German firms studied. This is a much higher level of internationalisation compared to, for example, a level of 42% reported by Gomes and Ramaswamy (1999). Also, Germany is a country that is comparatively much smaller both in terms of population and geography. It is also not physically detached from its many neighbours and other surrounding countries, with which a great deal of relatively free international trade exists for decades among EU countries and non-EU countries. Thus, the rationale of transaction

cost (Williamson, 1975) increasing after a certain level of involvement in international markets might not apply to the German context, or even to the European context for that matter due to greater market familiarity (Davidson, 1983; Eramilli, 1991; Papadopoulos and Denis, 1988). Because of the closer economic and cultural ties, and geographical proximity of the different markets, it is likely that transaction costs are less critical and lower compared to US firms' international operations due to the knowledge developed (Franko, 1976; Johanson and Vahlne, 1977; Melin, 1992).

6   Conclusion

The contribution of this paper is twofold. First, it provides a replication to the study of the relationship between internationalisation and performance, thereby testing the recent claims that there exists a curvilinear relationship. Second, it does so by diverging from previous studies that mostly employed US samples and instead uses a sample of German multinational firms that reveal qualitative differences. Results indicate support for the linear effect of internationalisation (Hypothesis 1), but no support for the non-linear effect (Hypothesis 2).

As mentioned earlier, the relationship between internationalisation and firm performance has been an important topic for researchers in strategic management and international business. Stopford and Wells' (1972) study was among the first research attempts that empirically examined the effect of internationalisation on firm performance. Since then, various studies have been conducted examining the same relationship, often with different theoretical and methodological aspects.

The widely accepted importance of this research stream comes from the fact that international expansion represents an alternative growth strategy to product diversification (Ansoff, 1965) that is likely to have a major effect on firm performance. Despite the numerous studies that have examined the association between internationalisation and performance, these efforts have provided evidence of conflicting results (Annavarjula and Beldona, 2000; Kirca et al.; Nguyen, 2017). On the other hand, a more recent stream of research has focused on potential methodological and theoretical causes that might explain the lack of consistent findings. In this light, some recent works have argued that there exists a curvilinear relationship between internationalisation and performance as opposed to a linear relationship, which has been the underlying premise in earlier studies. Unfortunately, there has been still insufficient evidence in this regard since there exist only a few studies rendering support to this argument. The present paper intended to fill this gap by testing the curvilinear hypothesis (and the linear effect hypothesis). In addition, most previous studies that have examined the internationalisation-performance relationship were based on samples of US firms. Thus, it has been argued in this paper that the same theoretical framework might not apply, and consequently the findings might not exactly hold for firms from other countries.

The study also has several limitations. First, contrary to some studies, internationalisation was measured by only a single indicator, namely the foreign sales to total sales ratio. Ideally, it is desirable to have multiple indicators to capture the international activities of firms more fully. However, constraints in data availability hindered this attempt. Secondly, the study was based on German multinationals. Thus, generalisability to firms from other countries should be done cautiously.

Future replication studies based on other non-US-based samples might be beneficial, which could provide more evidence as to the nature of the relationship between internationalisation and performance. Future studies should also include product diversity as a moderator variable. As demonstrated by Hitt et al. (1997), the relationship between international diversity and performance is moderated by product diversity. Furthermore, it might be also useful to include R&D and advertising intensity as moderators, since these two variables are likely to add some explanatory power to the relationship between international diversity and firm performance. Firm level resources (Barney, 1991) such as these are likely to contribute to better understanding the differences in performance levels of international firms. Finally, recent studies have also looked at ownership as an important factor affecting the relationship between internationalisation and performance (Sanchez-Bueno and Usero, 2014).

In conclusion, this paper examined the relationship between internationalisation and performance by using a sample of German firms. Indeed, the results of this study did not support the curvilinear hypothesis. Instead, evidence was found in favour of a linear relationship between internationalisation and performance. It is clear that further studies are needed to better uncover the relationship between internationalisation and performance.

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